



DEFENSE CONTRACT AUDIT AGENCY
AUDIT REPORT NO. 3311-2004K21000028



September 16, 2004

PREPARED FOR: Procuring Contracting Officer
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SUBJECT: Report on Audit of Proposal for Restore Iraqi Oil Task Order No. 6

REFERENCES: PCO: Contract No. DACA63-03-D-0005
Relevant Dates: See Page 26

CONTRACTOR: Kellogg Brown & Root Services, Inc.
A Division of Kellogg Brown & Root, Inc.
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REPORT RELEASE RESTRICTIONS: See Page 27

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SUBJECT OF AUDIT

As requested by the U.S. Army Corps of Engineers on May 17, 2004, we examined the Kellogg Brown & Root Services, Inc. (KBR) May 16, 2004 Cost-Plus-Award-Fee proposal for Task Order (TO) 6 under Contract No. DCAC63-03-D-0005, RIO I, to determine if the proposed costs are acceptable as a basis to negotiate a fair and reasonable task order price. The \$212,191,705 proposal provides support for restoration support services in response to the Notice to Proceed (NTP) issued by the Procuring Contracting Officer (PCO) on December 5, 2003. The proposed period of performance is December 8, 2003 through December 7, 2004.

The proposal and related cost or pricing data are the responsibility of the contractor. Our responsibility is to express an opinion on the proposal based on our examination.

EXECUTIVE SUMMARY

However, should negotiations proceed the following significant issues should be considered in the negotiation process.

Unsupported Subcontracts
Overstated Subcontracts

SIGNIFICANT ISSUES:

1. We have not received our requested technical analysis regarding the reasonableness of proposed labor hours and requirements for subcontracts, material, equipment, and other direct costs.

4. KBR proposed direct costs of [REDACTED] while [REDACTED] was charged to the RIO 6 Job Cost Ledger as of August 28, 2004. KBR's did not update the proposal to included current and accurate recorded costs. [REDACTED]

. Any

analysis and consideration of recorded costs during negotiations should include the impact of these adjustments to ensure accuracy of the cost information. [REDACTED]

SCOPE OF AUDIT

We conducted our examination in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the examination to obtain reasonable assurance that the proposal is free of material misstatement. An examination includes:

- evaluating the contractor's internal controls, assessing control risk, and determining the extent of audit testing needed based on the control risk assessment;
- examining, on a test basis, evidence supporting the amounts and disclosures in the proposal;
- assessing the accounting principles used and significant estimates made by the contractor;
- evaluating the overall proposal presentation; and
- determining the need for technical specialist assistance.

We evaluated the proposed costs using the applicable requirements contained in the:

- Federal Acquisition Regulation (FAR),
- Defense FAR Supplement (DFARS), and
- Cost Accounting Standards (CAS).

[REDACTED]

[REDACTED]

The scope of our examination reflects our assessment of control risk and includes audit tests designed to provide a reasonable basis for our opinion.

RESTRICTIONS

1. On May 21, 2004, we requested a technical evaluation to determine the reasonableness of proposed labor hours and requirements for subcontracts, material, equipment, and other direct costs from the U.S. Army Corps of Engineers. We contacted Mr. Vernon Vann, Corps of Engineers, regarding the completion of the technical evaluation. As of September 1, 2004 the technical evaluation was not complete. At the request of the Corps of Engineers, we are issuing our report without the technical evaluation. The technical results are considered essential to the evaluation of this task order. If the technical report materially impacts our audit findings and contractor negotiations have not been completed, we will issue a supplemental report incorporating the results of the technical evaluation.

2. A significant proportion of the contractor's proposed subcontractor costs are unsupported [REDACTED]. The unsupported costs are the result of the assist audit and are detailed in Audit Report 2131-2004R27000002 S1 (Appendix 1). If the contractor furnishes adequate supporting documentation prior to negotiations, we will provide a supplemental report to dispose of the unsupported costs if such a report would serve a useful purpose.

3. As part of our accounting system review, KBR disclosed that it was in the process of performing a detailed analysis of RIO transactions, particularly fuel related transactions. The purpose of this analysis is to ensure the accuracy of recorded information and its consistency with supporting documents. [REDACTED]

[REDACTED] Since KBR has not reflected all adjustments in its official books and records, we are unable to perform our review of the correcting entries. KBR plans to complete its analysis and process the adjusting journal vouchers in the near future. Our office plans to review adjusting entries when KBR's adjustments are completed. Therefore, our results of audit on this proposal are subject to change accordingly.

RESULTS OF AUDIT

[REDACTED] We believe the following items are of specific concern; therefore, negotiations should not be concluded until the issues are resolved.

- Unsupported costs of approximately [REDACTED] KBR should provide current, accurate and complete cost and pricing data including adequate cost or price analysis to resolve the unsupported costs.

- KBR proposed direct costs of [REDACTED] while [REDACTED] was charged to the RIO 6 Job Cost Ledger as of August 28, 2004. KBR's did not update the proposal to included current and accurate recorded costs. [REDACTED]

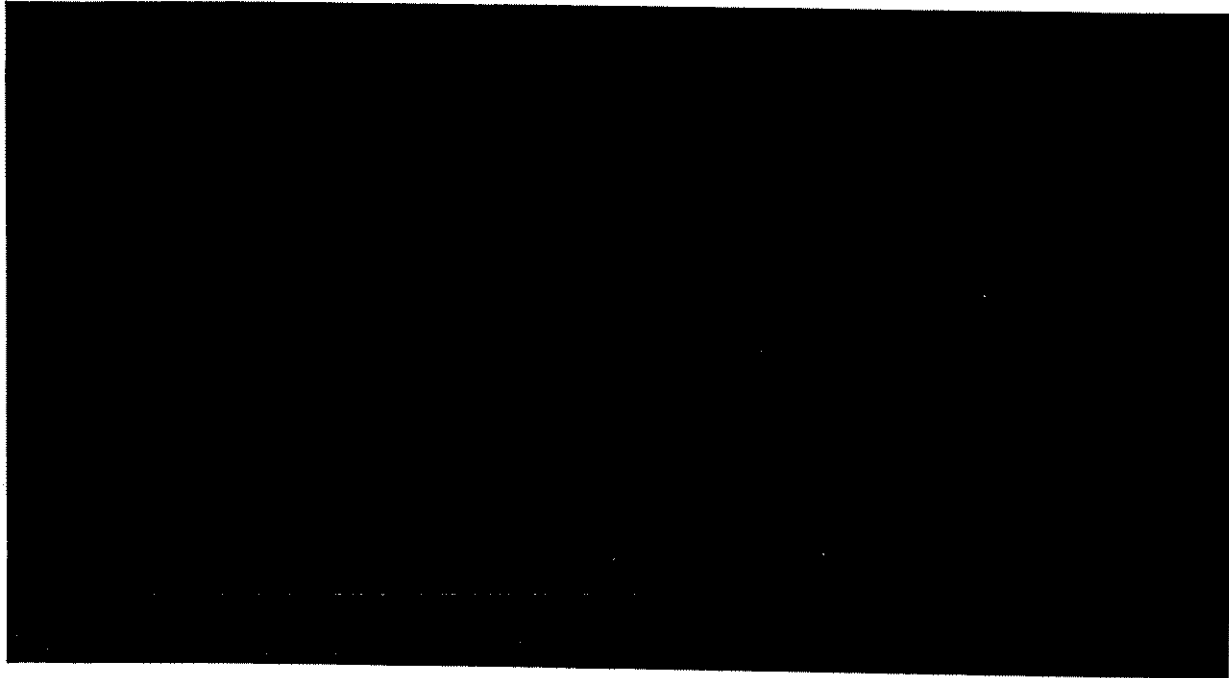
[REDACTED] Any analysis and consideration of recorded costs during negotiations should include the impact of these adjustments to ensure accuracy of the cost information. (See Restriction Note 3 for further details.)

At your request, we have, nevertheless, evaluated the proposal [REDACTED]. As a result, our examination of the [REDACTED] proposal disclosed [REDACTED] in questioned costs and [REDACTED] in unsupported costs. The detailed results of audit are contained in Exhibit A, Page 5.

We discussed factual matters concerning our findings with Mr. Brian Fee, Government Compliance, throughout the audit and during a final exit conference held on July 27, 2004. We did not provide the dollar impact of our findings. Issues that are agreed with are noted in the contractor's reaction paragraph for each exhibit note. For unsupported issues KBR will continue to provide documentation up to negotiations. We are available to provide you with assistance in resolving the reported findings.

EXHIBIT A

SUMMARY OF CONTRACTOR'S PROPOSAL
AND RESULTS OF AUDIT



EXPLANATORY NOTES

1. The amounts in this column are presented solely for the convenience of the procurement activity in developing its negotiating objective. They represent only the arithmetic difference between the amounts proposed and the related questioned costs. You should not consider the amounts to be audit approved or recommended amounts. DCAA does not approve or recommend prospective costs because the amounts depend partly on factors outside the realm of accounting expertise, such as opinions on technical and production matters.

2. Labor

a. Summary of Conclusions

We questioned [REDACTED] of proposed labor costs. Questioned costs are based on questioning 10 percentage points associated with danger pay and area differential in Kuwait. Questioned costs by each element are shown in the schedule below.



b. Basis of Contractor's Cost

Labor hours are based on incurred labor and forecasted hours for the remaining performance period. Direct labor includes "uplifts" [REDACTED] for in-country personnel. [REDACTED] include Foreign Service bonus [REDACTED] area differential and danger pay [REDACTED] Labor rates used in this proposal are the actual labor rates presented by KBR; [REDACTED]

[REDACTED] The Home Office Support rate is based on an average of employee rates that perform jobs under these job classifications. KBR stated the rates are within the company's established salary grade range for the positions and are in line with pay rates of other employees performing like functions in support of this contract.

c. Audit Evaluation



We believe overseas allowances in excess of the Department of State Standardized Regulations (DSSR) are unreasonable. Accordingly, we are questioning [REDACTED], as shown in the schedule above. We questioned [REDACTED] percentage points of the proposed [REDACTED] percent rates after May 18, 2004 when the DSSR danger pay and area differential pay rates dropped from 25 percent to 15 percent in Kuwait.

We reviewed the proposal for Rest and Relaxation (R&R) leave. [REDACTED] [REDACTED]. We also reviewed the contractor's proposed labor rates without exception. We compared the proposed labor rates to the staffing list for TO 6 and verified development of the average monthly salaries.

d. Contractor's Reaction

KBR does not agree to the questioned costs relating to danger pay or area differential. The contractor believes the DSSR rates are guidance only and KBR is not subject to the suggested rates.

e. Auditor's Response

Our position remains the same. The costs for danger pay and area differential are unreasonable based on a comparison to the allowance provided in the Department of State Standardized Regulations (DSSR).

3. Other Labor Related Costs

a. Summary of Conclusions

We questioned [REDACTED] of OLRC. Questioned costs result from the application of the proposed and audited OLRC rate of [REDACTED] percent to the questioned labor base.

b. Basis of Contractor's Costs

Proposed OLRC, sometimes called labor burdens, consist of labor insurance premiums, payroll burdens, and insurance and retirement benefits. Incurred OLRC is based on recorded cost for personnel in support of TO 06. The OLRC included in the proposal represents estimated burden rates and were applied to labor as appropriate.

c. Audit Evaluation

We questioned [REDACTED] of associated OLRC expenses relating to the questioned direct dollars as discussed in Note 2 above. We compared the CONUS and the OCONUS rates to the cost parameter worksheet to the current forward pricing rate recommendation (FPRR), [REDACTED]. Rates used by KBR in the proposal were the same or lower than those in the FPRR. Differences did not result in a material impact. We also reviewed the proposal for the correct application of [REDACTED] medical insurance in order to determine if the contractor adjusted the premium to account for employees with dependent coverage and single coverage. [REDACTED]

[REDACTED] We are currently reviewing the burden and benefits rates; therefore, we recommend the audit position or the latest DCMA recommended rates be used at negotiations, if available. Also, as discussed above, [REDACTED] direct labor may need to be reclassified prior to negotiation. As such, OLRC associated with reclassified labor would also be questioned.

d. Contractor's Reaction

KBR understands the associated OLRC expense; however, since they do not agree with the questioned labor base, they also do not agree to the questioned ORLC.

4. Equipment

a. Summary of Conclusions

We take no exception to the proposed equipment costs. Equipment was reviewed by the IBO as documented in Audit Report 2131-2004R27000002, S1 included as Appendix 1.

b. Basis of Contractor's Costs

Proposed equipment costs represent equipment leases which are based on competitive vendor quotes, purchase orders, subcontracts and/or change order documentation. These quotes included daily rates submitted under various lease terms throughout the period of August 2003 to April 2004.

c. Audit Evaluation

The following schedule represents the items reviewed under this cost element.



We selected all proposed equipment purchases in excess of \$500,000 and all items based on quotes, estimates and forecast for transaction testing, resulting in the identification and examination of [REDACTED], or [REDACTED] percent of proposed material. We requested an assist audit from the DCAA IBO for the entire sample because KBR indicated that the support for those items was maintained in-country. We reconciled the proposed equipment vendor amounts to KBR's procurement files and reviewed those files to determine whether cost or pricing analyses were performed. We compared these proposed costs to the various vendor quotes to verify reasonableness, validity, and existence of competition. We reviewed the cost of equipment items for allowability, allocability, reasonableness and performed a review of the contractor's cost or price analysis. When applicable, we considered lease versus buy options. Appendix 1 details the complete analysis of equipment costs.

5. Material

a. Summary of Conclusions

We questioned [REDACTED] of proposed material costs. Questioned costs are based on disclosure of more current, accurate and complete cost and pricing data.

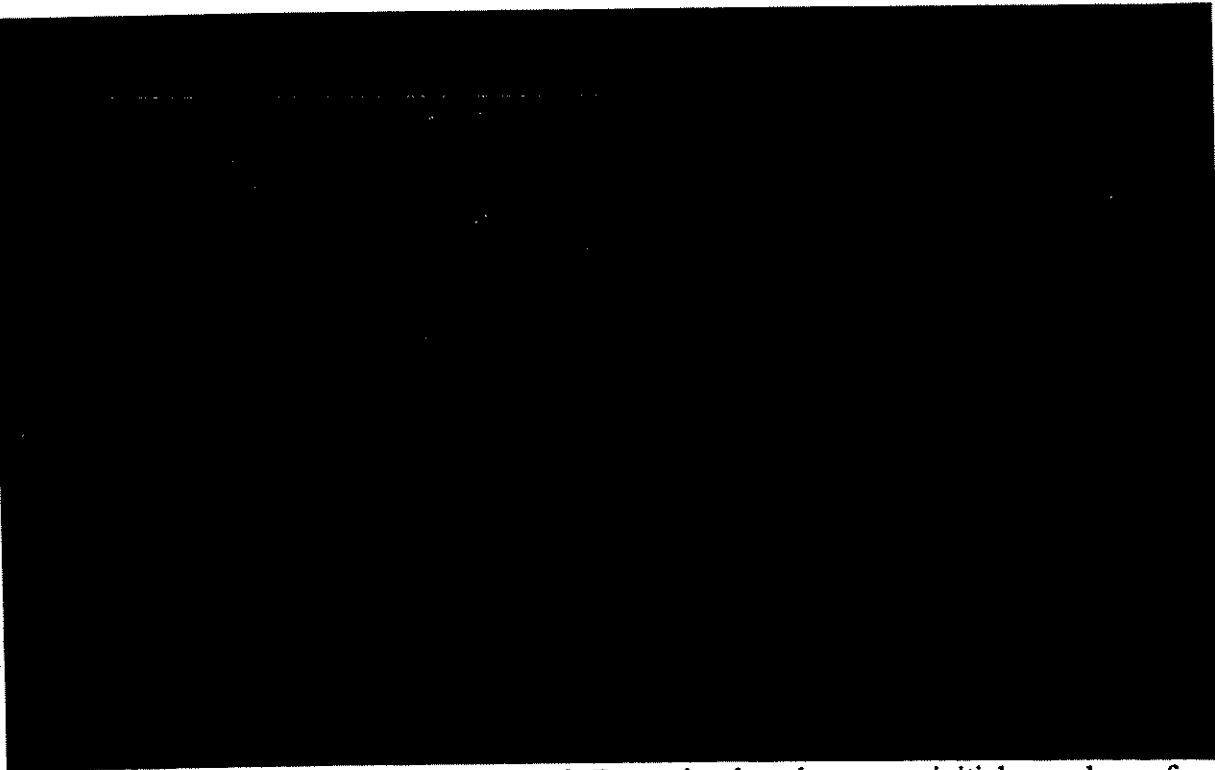
b. Basis of Contractor's Costs

KBR proposed material costs based on estimates, forecasts, history, and purchase orders.

c. Audit Evaluation

We selected all purchase orders in excess of [REDACTED] and all items based on quotes, estimates and forecast for transaction testing, resulting in the identification and examination of [REDACTED] or [REDACTED] percent of proposed material. We requested an assist audit from the DCAA IBO for [REDACTED] of the sample because KBR indicated that the support for those items was maintained in-country. We reviewed the remaining [REDACTED] at KBR's Houston site. We reviewed the procurement files, reconciled the proposed amounts, and determined that the contractor performed cost or price analysis as required by FAR 15.4.

We reviewed the cost of material items for allowability, allocability, reasonableness and performed a review of the contractor's price analysis. We verified costs to the "actual cost data base". We questioned costs based on disclosure of more current, accurate and complete costs and pricing data. The following schedule represents the items reviewed under this cost element.



(1) Bentonite - KBR proposed Bentonite based on an initial purchase from [REDACTED] of [REDACTED] and forecast of an additional purchase from [REDACTED] of [REDACTED]. Our review of [REDACTED] under agreement [REDACTED] confirmed that an initial order had been placed for [REDACTED], and that the second order had been placed for [REDACTED]. Questioned costs of [REDACTED] represent the difference between the forecast and actual purchase of the final bentonite order.

(2) Fuel Supply - As discussed in Assist Audit Report 2131-2004R27000002 S1 (Appendix 1), KBR purchased fuel from [REDACTED]. According to the purchase order, fuel prices have decreased resulting in the [REDACTED] in questioned costs.

(3) Various Purchases - As discussed in Assist Audit Report 2131-2004R27000002 S1 (Appendix 1), KBR submitted these two line items [REDACTED] to account for allowances for Change Orders. The amounts proposed are based on the contractor's estimate. More current data is available from the "actual cost data base" and has resulted in [REDACTED] in questioned costs.

d. Contractor's Reaction

KBR will review the procurement files prior to negotiations and provide any updated information at that time.

6. Subcontracts

a. Summary of Conclusions

We questioned [REDACTED] and classified as unsupported [REDACTED] of proposed subcontractor cost. The unsupported costs are from DCAA Assist Audit Report 2131-2004F27000002 S1 (Appendix 1) [REDACTED]

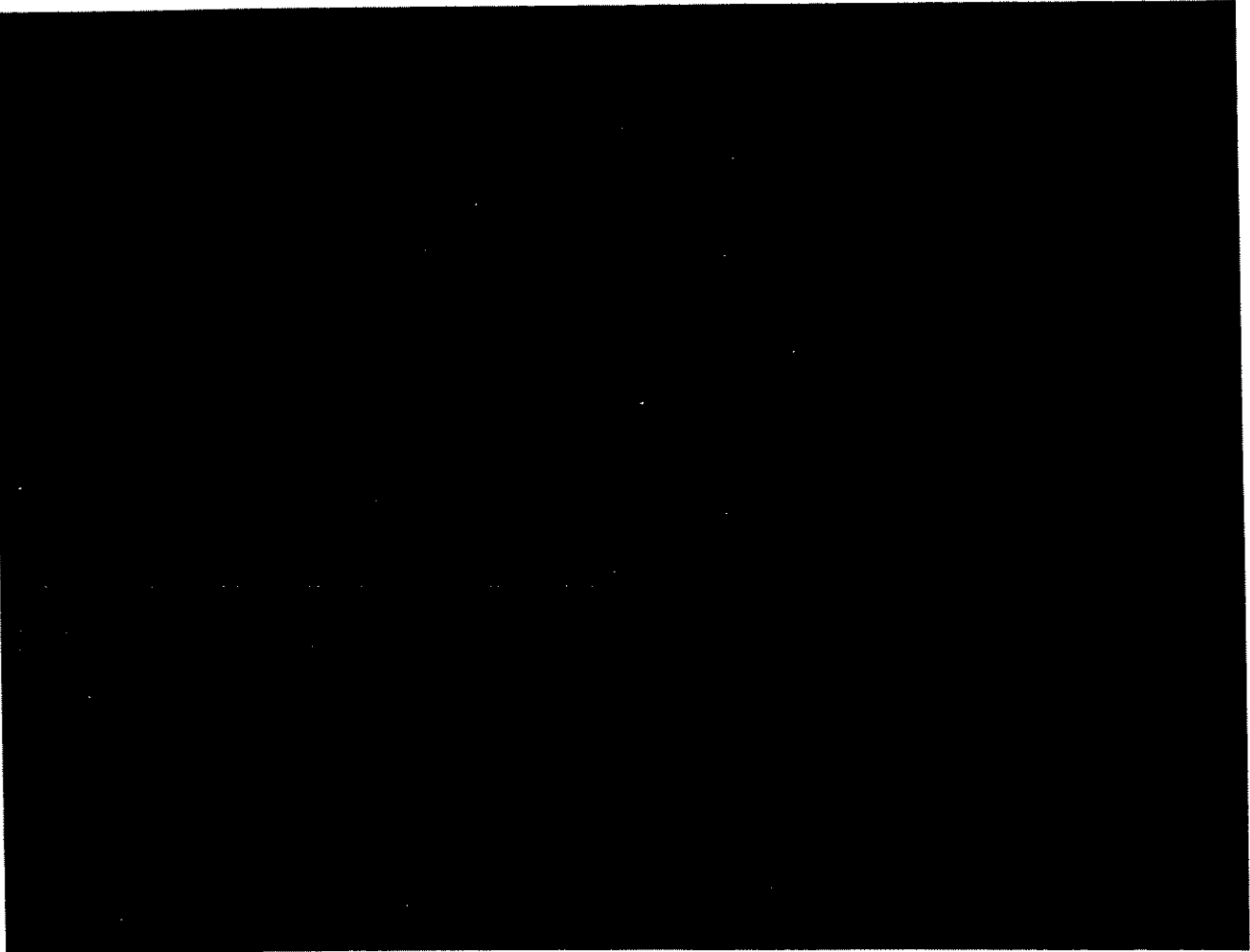
[REDACTED] Questioned costs are due to disclosure of more current, accurate, and complete cost and pricing data and correction of errors in the proposal.

b. Basis of Contractor's Costs

KBR proposed subcontractor costs based on estimates, forecasts, history, and actual subcontracts.

c. Audit Evaluation

The following schedule represents the items reviewed under this cost element.



We selected all proposed subcontracts in excess of \$500,000 and all subcontract items based on quotes, estimates and forecast for transaction testing, resulting in the identification and examination of [REDACTED] or [REDACTED] percent of proposed subcontracts. We requested an assist audit from the DCAA IBO for [REDACTED] of the sampled items. [REDACTED]

[REDACTED] Therefore, we reviewed the procurement files; consequently we eliminated unsupported dollars reported in the assist audit report (Appendix 1) and questioned [REDACTED] as discussed in subparagraph (1) below.

We reviewed the remaining items at KBR's Houston site. We reconciled the proposed amounts to KBR's subcontract procurement files and examined supporting data included in the

subcontract files. When possible we reviewed these files to determine that proper cost or price analyses were performed. We examined bids submitted by all competitors and reviewed KBR justification when award was not made based on the lowest bid. We compared proposed costs to the various vendor quotes to verify reasonableness, validity, and existence of competition

(1) Based on DCAA Assist Audit Report 2231-2004R27000002 S1 (Appendix 1), we classified as unsupported [REDACTED]

(2) We questioned [REDACTED] based on disclosure of more current, accurate and complete cost and pricing data and correcting of errors in the proposal. The following subparagraphs detail the questioned costs.

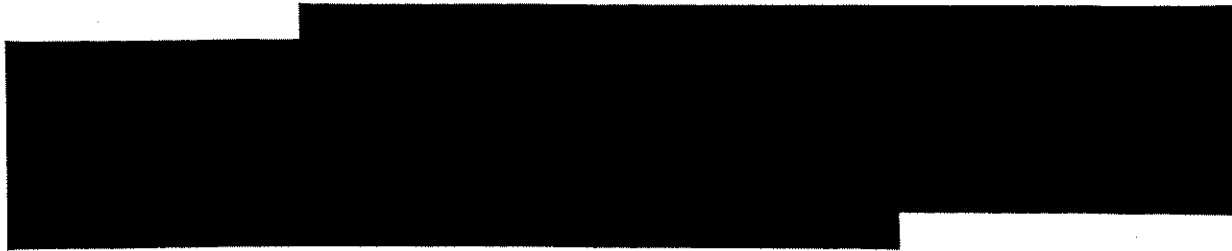
(a) [REDACTED] - Questioned costs represent costs identified with TO 3 erroneously included in the TO 6 proposal.

(b) [REDACTED] - Questioned costs of [REDACTED] represent the excess of proposed costs [REDACTED] over the subcontract NTE price of [REDACTED]. As of May 29, 2004, [REDACTED] had been paid on this subcontract. The subcontract was estimated to be complete by August 22, 2004. This supports our position that the negotiated subcontract price is a reasonable estimate of the final price. We have not questioned the difference between the NTE price of [REDACTED] and the incurred costs of [REDACTED]. However, if during negotiations, the incurred costs on this subcontract are less than the NTE price then that difference should also be questioned.

(c) [REDACTED] - As discussed in Assist Audit Report 2131-2004R27000002 S1 (Appendix 1), KBR proposed a total of [REDACTED] to provide customer support services worldwide. These services include:

- supervising or carrying out the complete installation and commissioning of new or relocated equipment;
- providing long or short term operation and maintenance services;
- carrying out routine service work;
- providing a troubleshooting service; and
- providing 'hands-on' site training for user's, operators and maintenance personnel.

Price breakdown is as follows:



(3) Subcontract [redacted] for [redacted]

[redacted] Therefore, we reviewed the procurement files; consequently we eliminated unsupported dollars reported in the assist audit report (Appendix 1) and questioned [redacted] as discussed in subparagraph (2)(a) above.

d. Contractor's Reaction

KBR will review the procurement files prior to negotiations and provide any updated information at that time.

7. Other Direct Costs

a. Summary of Conclusions

We questioned [redacted] of proposed ODC costs based on disclosure of more current, accurate and complete cost and pricing data. Construction freight was proposed based on an outdated estimate instead of the purchase order agreement. Details regarding the questioned costs are included in DCAA Audit Report 2131-2004F27000002 S1 (Appendix 1).

b. Basis of Contractor's Costs

KBR proposed ODC's based on estimates and purchase orders. In the proposal narrative KBR states ODC's includes items such as corporate charges, communications, mail, services provided by others and interim transit travel.

c. Audit Evaluation

The following schedule represents the items reviewed under this cost element.

[REDACTED]

We selected all purchase orders in excess of \$500,000 and all items based on quotes, estimates and forecast for transaction testing. This resulted in the identification and examination of [REDACTED] or [REDACTED] percent of proposed ODC. We requested an assist audit from the DCAA IBO for [REDACTED] of the sample because KBR indicated that the support for those items was maintained in-country. We reviewed the remaining [REDACTED] at KBR's Houston site. We reviewed the supporting documentation (i.e. purchase orders) to verify reasonableness, validity, and existence. The assist audit report found freight cost proposed based on an outdated estimate; therefore we questioned [REDACTED] which is the difference between the estimate and the purchase order documentation.

d. Contractor's Reaction

KBR will coordinate with their in-country office and provided additional support prior to or at negotiations.

8. Overhead

a. Summary of Conclusion

We questioned [REDACTED] of segment overhead. Questioned costs are due to questioning [REDACTED] percentage points of the proposed rate [REDACTED]. Our position is based on developing a composite rate [REDACTED] using the Forward Pricing Rate Recommendation (FPRR), dated [REDACTED], as applied to the direct costs by year. For TO 6 period of performance, years 2003 and 2004, there is no change in the overhead rate recommendation between the [REDACTED] FPRR and the [REDACTED] FPRR. Additional questioned costs are due to questioned direct costs. Overhead costs applicable to unsupported costs have not been quantified. Overhead should be applied to any unsupported costs not accepted during negotiations. Detailed calculations are shown in subparagraph c – Audit Evaluation below.

b. Basis of Contractor's Costs

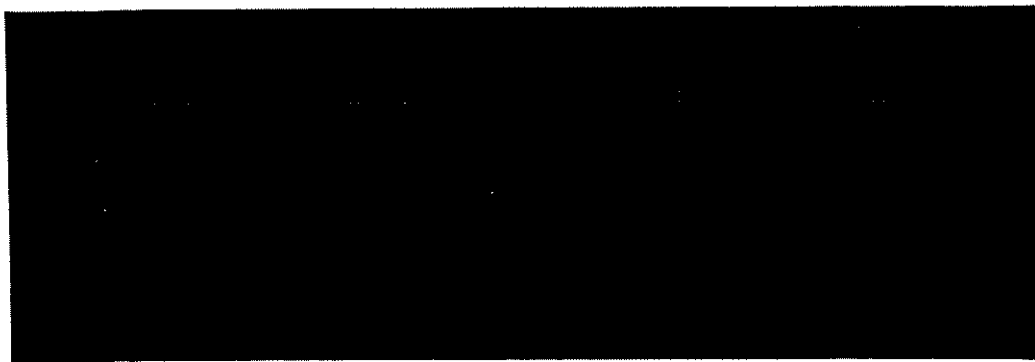
KBR's proposal narrative states the segment overhead is based on the preliminary 2004 FPRR. The stated overhead rate is [REDACTED] percent; however, the applied overhead is [REDACTED] percent. The allocation base for segment overhead is total direct costs.

c. Audit Evaluation

Questioned segment overhead of [REDACTED] is due to questioning the composite overhead rate and also questioned base costs. The following schedule details questioned segment overhead costs. Also, the following schedules contain minor rounding errors due to carrying the audit rate to [REDACTED] decimal points to be consistent with the proposed composite rate calculations.



The audit composite rate is developed as shown in the schedule below. Our rate calculates the segment overhead expense based on the dollars proposed by FY and the FPRR rates for FY 2003 [REDACTED] and FY 2004 [REDACTED]. This aligns the dollars with the appropriate indirect rates.



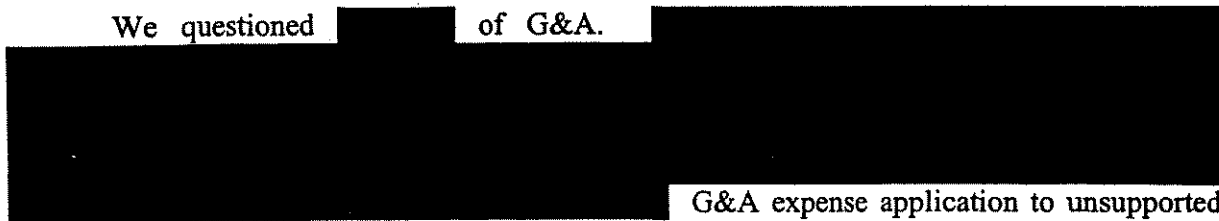
d. Contractor's Reaction

The contractor does not agree with all questioned costs; therefore, they do not agree with indirect adjustments either.

9. G&A Expense

a. Summary of Conclusion

We questioned [REDACTED] of G&A.



G&A expense application to unsupported

costs have not been quantified. G&A should be applied to any unsupported costs not accepted during negotiations.

b. Basis of Contractor's Costs

KBR's proposal narrative states the G&A rate is based on the preliminary 2004 FPRR. The stated G&A rate is [REDACTED] percent; however, the applied G&A rate is [REDACTED] percent. The allocation base for G&A is total direct costs plus overhead.

c. Audit Evaluation

Questioned G&A of [REDACTED]

The audit composite rate is developed as shown in the schedule below. [REDACTED]

[REDACTED]. This aligns the dollars with the appropriate indirect rates.

d. Contractor's Reaction

The contractor does not agree with all questioned costs; therefore, they do not agree with indirect adjustments either.

10. Facility Capital Cost of Money (FCCOM)

a. Summary of Conclusion

We questioned [REDACTED] of FCCOM. Questioned costs are due solely to questioned base costs.

b. Basis of Contractor's Costs

[REDACTED]

c. Audit Evaluation

Questioned FCCOM is based on applying the proposed FCCOM factor [REDACTED] to the questioned base costs as shown below:

[REDACTED]

d. Contractor's Reaction

The contractor does not agree with all questioned costs; therefore, they do not agree with indirect adjustments either.

CONTRACTOR ORGANIZATION AND SYSTEMS

1. Organization

On May 21, 2004 and July 13, 2004, we requested organizational information on Halliburton owned legal entities and how they relate to each other. [REDACTED]

[REDACTED]. Based on the information we have, Halliburton's business is organized into two groups, the Engineering and Construction Group and the Energy Services Group (ESG). ESG includes four business segments – Drilling and Formation Evaluation, Fluids, Production Optimization, and Landmark and Other Energy Services. The Engineering and Construction Group (E&C) operates as KBR. This group provides engineering, procurement, construction, project management, facilities operation, and maintenance for oil and gas to industrial and Governmental customers.

In 2003, KBR transferred its U.S. Government contracts to Kellogg Brown & Root Services, Inc. (KBR SI), a division of KBR, and Halliburton provided a performance guarantee for the transferred contracts. KBR SI is responsible for performance of the Logistics Civil Augmentation Program (LOGCAP III), Restore Iraqi Oil (RIO) program, and Balkans support contracts. LOGCAP III, with a ceiling of [REDACTED], provides contingency/wartime logistics support to military and civilian personnel for more than 80 locations worldwide. RIO consists of two contracts: one for the rebuilding of Iraqi oil infrastructure with a contract value of [REDACTED] and one for the restoration of southern Iraqi oil fields with a contract value of [REDACTED]. The Balkans support contract provides full logistic services to U.S. troops in the Balkans region. Halliburton has provided a corporate guarantee for the LOGCAP, RIO, and Balkans support contracts.

Halliburton revenues and personnel worldwide for prior fiscal years and projected revenues for FY 2004 are as follows:

		2003	2002	2001
Total revenues (in millions)	[REDACTED]	\$16,271	\$12,572	\$13,046
U.S. Government sales	[REDACTED]	26%	<10%	<10%
Personnel	[REDACTED]	101,000	83,000	85,000

2. Systems

a. Accounting System

[REDACTED]

[REDACTED]

[REDACTED]

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General information on audit matters is available at <http://www.dcaa.mil>.

RELEVANT DATES

Request for Audit: PCO—dated May 17, 2004; received May 17, 2004

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/s/ Dan St. John

/For/ William F. Daneke
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DCAA Arlington Branch Office

AUDIT REPORT DISTRIBUTION AND RESTRICTIONS

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RESTRICTIONS

1. Information contained in this audit report may be proprietary. It is not practical to identify during the conduct of the audit those elements of the data which are proprietary. Make proprietary determinations in the event of an external request for access. Consider the restrictions of 18 U.S.C. 1905 before releasing this information to the public.
2. Under the provisions of Title 32, Code of Federal Regulations, Part 290.7(b), DCAA will refer any Freedom of Information Act requests for audit reports received to the cognizant contracting agency for determination as to releasability and a direct response to the requestor.
3. The Defense Contract Audit Agency has no objection to release of this report, at the discretion of the contracting agency, to authorized representatives of KBR.
4. Do not use the information contained in this audit report for purposes other than action on the subject of this audit without first discussing its applicability with the auditor.

INDEX TO APPENDICES

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**DCAA IRAQ BRANCH OFFICE
KUWAIT BRANCH OFFICE
AUDIT REPORT No. 2131-2004F27000002 S1**

The above reference audit report is attached in its entirety.



DEFENSE CONTRACT AUDIT AGENCY
AUDIT REPORT NO. 2131-2004R27000005



August 17, 2004

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SUBJECT: Report on Assist Audit of Sampled Items for Material Costs Proposed
Under Contract No. DACA63-03-D-0005 (RIO I), Task Order 6
Definitization Proposal

REFERENCES: DCAA Reference No.: 3311-2004K21000028
Contract No. DACA63-03-D-0005
Relevant Dates: See Page 26

CONTRACTOR: Kellogg Brown and Root. (KBR)
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REPORT RELEASE RESTRICTIONS: See Page 27

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FOR OFFICIAL USE ONLY

SUBJECT OF AUDIT OF PARTS OF A PROPOSAL

As requested by the Arlington Branch Office (ABO) on August 13, 2004, we examined the requested sample items for material costs [REDACTED] in Kellogg Brown and Root's (KBR) cost plus award fee proposal dated May 16, 2004 to determine if the parts of the proposal examined are acceptable as a basis to negotiate a fair and reasonable contract price. KBR submitted the proposal to definitize Task Order 6 under Restore Iraqi Oil (RIO) Contract No. DACA63-03-D-0005.

The proposed sample selection for material costs and related cost or pricing data are the responsibility of the contractor. Our responsibility is to express an opinion on the sample selection for material costs based on our examination.

SCOPE OF AUDIT OF PARTS OF A PROPOSAL

As requested, we limited our examination to the proposed sample selection identified in your request. Except as discussed in the qualification section of the report, we conducted our examination in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether the parts of the proposal examined are free of material misstatement. An examination includes:

- evaluating the contractor's internal controls, assessing control risk, and determining the extent of audit testing needed based on the control risk assessment;
- examining, on a test basis, evidence supporting the amounts and disclosures for the parts of the proposal audited;
- assessing the accounting principles used and significant estimates made by the contractor in developing the proposed amounts for the parts of the proposal audited;
- evaluating the overall presentation for those parts; and
- determining the need for technical specialist assistance for the parts of proposal audited.

We evaluated the proposed sample selection for material costs using the applicable requirements contained in the:

- Federal Acquisition Regulation (FAR);
- Defense Federal Acquisition Regulation Supplement (DFARS); and
- Cost Accounting Standards (CAS).

[REDACTED]

The scope of our examination reflects our

assessment of control risk and includes audit tests designed to provide a reasonable basis for our opinion.

QUALIFICATION

- We were unable to determine by audit procedures the sufficiency of the quantities of the sampled items selected for Task Order No. 6. We were informed on May 12, 2004 that all technical requests have been requested from the ABO through the Central Region. The results of audit are qualified until we receive the technical report and determine its impact on this audit. If contract negotiations have not been concluded at that time and the technical report's findings materially impact our audit recommendations, we will issue a supplemental report incorporating the results of the technical evaluation.

RESULTS OF AUDIT OF PARTS OF A PROPOSAL

In our opinion, the offer has submitted adequate cost or pricing data in support of the sample selection for material. The amount proposed for material was prepared in accordance with applicable Cost Accounting Standards and appropriate provisions of FAR and DFARS. Therefore, we consider the proposal to be acceptable as a basis for negotiation of a fair and reasonable price for the proposed sample selections. This report is limited to the review of sample selection for material costs. Accordingly, we express no opinion on the contractor's proposal taken as a whole.

We noted no exceptions with the amount proposed for the sample selection. The details of our examination are summarized in the following notes.

We discussed factual matters concerning our findings with Mr. Bob Burton, KBR-RIO Senior Compliance Analyst, in an exit conference held on August 17, 2004. Mr. Burton concurred with our findings. We did not provide the dollar impact of our findings.

STATEMENT OF PROPOSED COSTS AND RESULTS
OF AUDIT OF PARTS OF A PROPOSAL

EXPLANATORY NOTES:

1. Difference

The amounts in this column are presented solely for the convenience of the procurement activity in developing its negotiation objective. They represent only the arithmetic difference between the proposed costs and any related questioned or unsupported costs. The reader should not consider the costs to be audit approved or recommended amounts. DCAA does not approve or recommend prospective costs because the amounts depend partly on factors outside the realm of accounting expertise, such as opinions on technical and production matters.

2. Material

a. Summary of Conclusions:

We take no exception to the proposed material costs.

b. Basis of Contractor's Cost:

KBR proposed costs based on the vendor's quoted price, the purchase order amount, and the Change Order 1 (NTE) amount.

c. Audit Evaluation:

Following is the amount proposed:

We reviewed KBR's procurement file for Purchase Order No. RIO-JKKP02669. We found that KBR awarded the purchase order competitively. We reconciled the proposed amount to the purchase order, Change Order 1, the vendor's invoices, and the Wire Transfer Requests. The amount proposed for Task Order 6 under the purchase order, [REDACTED], represents the acquisition of one TM 2500 gas turbine.

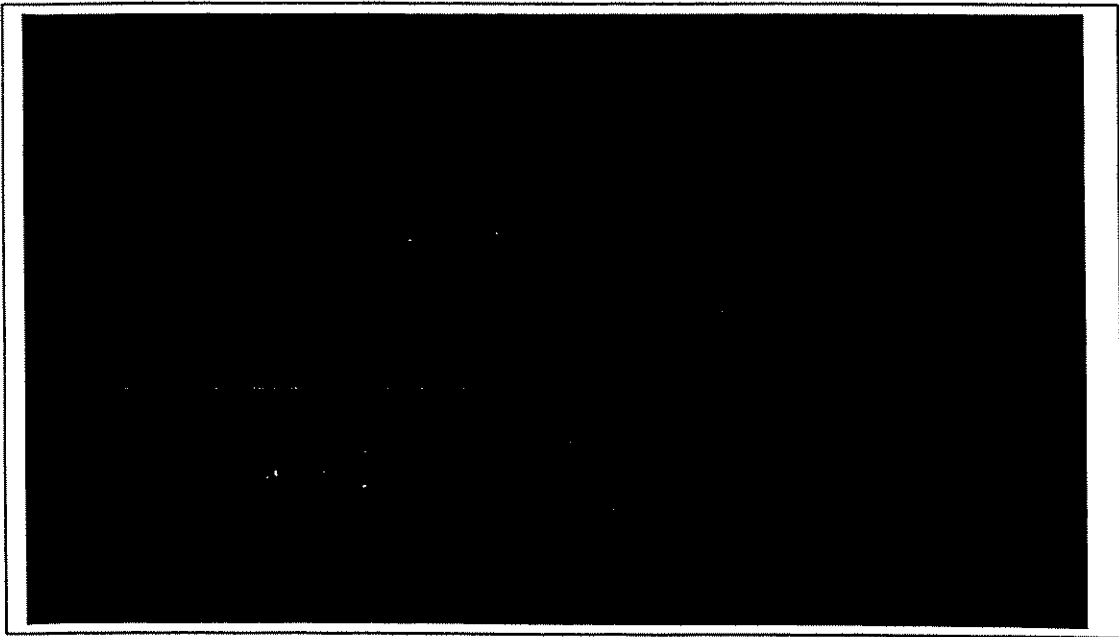
d. Contractor's Reaction:

The contractor concurred with our findings.

CONTRACTOR ORGANIZATION AND SYSTEMS

1. Organization

Halliburton's business is organized into two groups, the Engineering and Construction Group and the Energy Services Group (ESG). ESG includes four business segments – Drilling and Formation Evaluation, Fluids, Production Optimization, and Landmark and Other Energy Services. The Engineering and Construction Group operates as KBR and provides engineering, procurement, construction, project management, and facilities operation and maintenance for oil and gas and other industrial and governmental customers.



In 2003 KBR transferred its U.S. Government contracts to Kellogg Brown and Root. (KBR), a subsidiary of KBR, and provided a performance guarantee for the transferred contracts. KBR functions as part of KBR Government Operations. KBR is responsible for performance of the Logistics Civil Augmentation Program (LOGCAP III), Restore Iraqi Oil (RIO) program, and Balkans support contracts. LOGCAP III with a ceiling of [REDACTED] provides contingency/wartime logistics support to military and civilian personnel for more than 80 locations worldwide. RIO with a ceiling of [REDACTED] billion involves the rebuilding of Iraq and the Balkans support contract provides full logistic services to U.S. troops in the Balkans region. Halliburton has provided a corporate guarantee for the LOGCAP, RIO, and Balkans support contracts.

Halliburton revenues and personnel worldwide for prior fiscal years and projected revenues for FY 2004 are as follows:

	2004	2003	2002	2001
Total revenues (in millions)	██████████	\$16,271	\$12,572	\$13,046
U.S. Government sales	██████████	26%	<10%	<10%
Personnel		101,000	83,000	85,000

2. Systems

a. Accounting System

[illegible]

[REDACTED]

[REDACTED]

[REDACTED]

b. Estimating System

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

c. Subcontract Management System

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

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-------------------------------	---------------------------

DCAA Iraq Branch Office

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General information on audit matters is available at <http://www.dcaa.mil>.

RELEVANT DATES

Audit Request dated July 15, 2004 and received August 13, 2004

AUDIT REPORT AUTHORIZED BY:

	/s/ Curtis F. Bleibaum
/for/	James Carrera
	Branch Manager
	DCAA Iraq Branch Office

AUDIT REPORT DISTRIBUTION AND RESTRICTIONS

DISTRIBUTION

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RESTRICTIONS

1. Information contained in this audit report may be proprietary. It is not practical to identify during the conduct of the audit those elements of the data which are proprietary. Make proprietary determinations in the event of an external request for access. Consider the restrictions of 18 U.S.C. 1905 before releasing this information to the public.
2. Under the provisions of Title 32, Code of Federal Regulations, Part 290.7(b), DCAA will refer any Freedom of Information Act requests for audit reports received to the cognizant contracting agency for determination as to releasability and a direct response to the requestor.
3. The Defense Contract Audit Agency has no objection to release of this report, at the discretion of the contracting agency, to authorized representatives of KBR.
4. Do not use the information contained in this audit report for purposes other than action on the subject of this audit without first discussing its applicability with the auditor.



DEFENSE CONTRACT AUDIT AGENCY
AUDIT REPORT NO. 2131-2004R27000002 S1
(Revised)



Original S1 Date: August 4, 2004

Revised Date: August 5, 2004

PREPARED FOR: Defense Contract Audit Agency
Arlington Branch Office
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SUBJECT: Supplement to Report on Assist Audit of Definitization Costs Under the
RIO I, Task Order 06

REFERENCES: Audit Report No. 2131-2004R27000002, dated July 6, 2004
DCAA: 3311-2004K21000028
Contract No. DAAA09-02-D-0007
Relevant Dates: See Page 26

CONTRACTOR: Kellogg Brown & Root Services
Division of Halliburton Corporation
4100 Clinton Drive, Bldg 1 (648)
Houston, TX 77020-6237

REPORT RELEASE RESTRICTIONS: See Page 18

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SUBJECT OF SUPPLEMENTAL AUDIT OF PARTS OF A PROPOSAL

This supplemental report incorporates revisions to our original reported dated July 6, 2004 as a result of the re-examination of the cost avoidance factor applied to the proposed cost of leases included as elements of equipment and subcontract in Kellogg Brown and Root's (KBR) cost plus award fee proposal dated May 16, 2004. We have reconsidered aspects of the previously recommended cost avoidance factor after reviewing the contractor response to our draft audit report on Lease Acquisitions for Subcontracted Equipment and as a result are performing additional work. This supplemental report replaces our original report in its entirety.

As requested by the DCAA Arlington Branch Office (ABO), on June 10, 2004, we examined the [REDACTED] sample selections for the proposed material, equipment, ODC, and major subcontracts portion of Kellogg Brown & Root's Services (KBR's) cost plus award fee proposal dated May 16, 2004 to determine if the parts of the proposal examined are acceptable as a basis to negotiate a fair and reasonable contract price. KBR proposed a performance period of 117 days starting December 5, 2004.

The proposed material, equipment, ODC, major subcontracts, and related cost or pricing data are the responsibility of the contractor. Our responsibility is to express an opinion on the proposed sample selection items based on our examination.

SCOPE OF SUPPLEMENTAL AUDIT OF PARTS OF A PROPOSAL

As requested, we limited our examination to the proposed sample major subcontracts, ODC, equipment, and direct material costs. Except for the qualifications discussed below, we conducted our examination in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether the parts of the proposal examined are free of material misstatement. An examination includes:

- evaluating the contractor's internal controls, assessing control risk, and determining the extent of audit testing needed based on the control risk assessment;
- examining, on a test basis, evidence supporting the amounts and disclosures for the parts of the proposal audited;
- assessing the accounting principles used and significant estimates made by the contractor in developing the proposed amounts for the parts of the proposal audited;
- evaluating the overall presentation for those parts; and
- determining the need for technical specialist assistance for the parts of proposal audited.

We evaluated the proposed subcontract, ODC's, equipment, and direct material costs using the applicable requirements contained in the:

- Federal Acquisition Regulation (FAR);
- Defense Federal Acquisition Regulation Supplement (DFARS); and
- Cost Accounting Standards (CAS).

[REDACTED]

The scope of our examination reflects our assessment of control risk and includes audit tests designed to provide a reasonable basis for our opinion.

QUALIFICATIONS

1. We were unable to determine by audit procedures, the sufficiency of the quantities of the sampled items selected for Task Order 6. We were informed on May 12, 2004 that all technical requests have been requested from the Arlington Branch Office through the Central Region. Therefore, the audit results are qualified to the extent that additional costs may be questioned based on the results of the technical evaluation of the proposed quantities.
2. [REDACTED] portion of the costs proposed are classified unsupported. [REDACTED]

3. [REDACTED] Our report is qualified for any changes which would result from having visibility to the amounts proposed.

RESULTS OF SUPPLEMENTAL AUDIT OF PARTS OF A PROPOSAL

[REDACTED]

This report is limited to the review of major subcontract, ODC, equipment, and direct material costs of the proposal. [REDACTED]

We have questioned [REDACTED] and classified as unsupported [REDACTED] of the proposed costs. [REDACTED]

The details of our examination are summarized on the following page.

We discussed factual matters concerning our findings with Ms. Karen Chillcott, KBR Contracts Manager, and Mr. Bob Burton, Senior Compliance Analyst, and Mr. Mohammad Saleem, Lead Estimator in our exit conference held on July 6, 2004. KBR states it will attempt to furnish additional supporting documentation at or before negotiations. We did not provide the dollar impact of our findings.

STATEMENT OF CONTRACTOR'S PROPOSAL AND RESULTS OF SUPPLEMENTAL
AUDIT OF PARTS OF A PROPOSAL

	<u>Proposed</u> (Note 1)	<u>Questioned</u>	<u>Unsupported</u>	<u>Difference</u> (Note 2)	<u>Reference</u>
Equipment					Note 3
Material					Note 4
ODC					Note 5
Subcontract					Note 6
Total Evaluated					

EXPLANATORY NOTES

1. Proposed Costs

The proposed amounts are based on the sample items requested for examination. Our examination was based on the review of the sample ETC costs proposed as provided by ABO. The sample items selected for our review have not taken into account all of the credits for the incurred costs which were backed out of the ETC. The ABO will verify these costs and make appropriate adjustments because our office does not have visibility to the costs incurred in the proposal

2. Difference

The amounts in this column are presented solely for the convenience of the procurement activity in developing its negotiation objective. They represent only the arithmetic difference between the proposed costs and the related questioned and unsupported costs. You should not consider the costs to be audit approved or recommended amounts. DCAA does not approve or recommend prospective costs because the amounts depend partly on factors outside the realm of accounting expertise, such as opinions on technical and production matters.

3. Equipment

a. Summary of Conclusions:

We take no exception to the \$ [REDACTED] of the proposed equipment costs.

b. Basis of Contractor's Cost:

Proposed equipment costs represent equipment leases which are based on competitive vendor quotes, purchase orders, subcontracts and/or change order documentation. These quotes included daily rates submitted under various lease terms throughout the period of August 2003 to April 2004.

c. Audit Evaluation:

We reconciled the proposed equipment vendor amounts to KBR's procurement files and reviewed those files to determine whether cost or pricing analyses were performed. We compared these proposed costs to the various vendor quotes to verify reasonableness, validity, and existence of competition. We reviewed the cost of equipment items for allowability, allocability, reasonableness and performed a review of the contractor's cost or price analysis. When applicable, we considered lease versus buy options.

In our original audit report we recommended a cost avoidance factor for application to the proposed cost of leased assets [REDACTED]

[REDACTED] We are re-examining the cost avoidance factor we developed after reviewing the KBR response to our draft audit report on Lease Acquisitions for Subcontracted Equipment. As a result we are performing additional audit work.

An LVPA generally compares the purchase price of the assets to the cumulative lease payments, considering anticipated length of ownership, salvage value, time value of money and ownership costs. The use of LVPA is a normal and prudent business practice used by major corporations to determine the best value for acquiring property and equipment.

It should be noted that, over the course of evaluation of task order definitization proposals our analysis of various cost elements (subcontracts, material, equipment, and ODC) shows that KBR has leased and is still proposing to lease significant amounts of assets. In some cases the leases are short term (30 – 60 days) but most leases are proposed for extended periods of time, most frequently for 6 – 12 months with routine extensions for similar periods.

During several of our task order definitization proposal evaluations, we found evidence of some LVPAs having been performed by KBR. In the LVPAs performed by KBR, the breakeven point (the date at which it is more advantageous to purchase than to lease) ranged from 5 to 10 months. [REDACTED]

4. Material

a. Summary of Conclusions:

Based on our evaluation of the sample items, we questioned [REDACTED] of the proposed material amounts. The questioned costs result from the difference between the proposed costs and the supporting documentation.

b. Basis of Contractor's Cost:

The contractor based the majority of its proposed material costs on vendor quotes, actual purchase orders, estimates, subcontracts and/or change order documentation.

Audit Report No. 2131-2004R27000002 S1 (Revised)

c. Audit Evaluation:

We reviewed the files, reconciled the proposed amounts, and determined that the contractor performed cost or price analysis as required by FAR 15.4. We reviewed the cost of material items for allowability, allocability, reasonableness and performed a review of the contractor's price analysis. Finally, we reviewed cost data from the "actual costs data base" which resulted in the above mentioned questioned costs. The "actual costs data base" demonstrated there was no longer a need for the services and products proposed as "balance for purchase" by the contractor.

<u>Description</u>	<u>Proposed Amount</u>	<u>Questioned Amount</u>	<u>Ref.</u>
Supply fuel to Vendor			(i)
Balance for Purchase			(ii)
Balance for Purchase			(ii)
Total			

Notes:

(i) KBR purchased fuel from [REDACTED]. According to the purchase order fuel prices have decreased, resulting in the above mentioned questioned costs.

(ii) KBR submitted these line items to account for allowances for Change Orders. The amounts proposed are based on the contractor's estimate. More current data is available from the "actual cost data base" and has resulted in the above mentioned questioned costs.

5. Other Direct Costs (ODC)

a. Summary of Conclusions:

During our examination we reviewed [REDACTED] of the proposed ODC's. Of the reviewed amount we questioned [REDACTED] based on more current data.

b. Basis of Contractor's Cost:

KBR proposed these costs based on estimates and purchase orders.

c. Audit Evaluation:

We reviewed the supporting documentation (ie purchase orders) to verify reasonableness, validity, and existence. During our examination we found freight cost proposed based on an outdated estimate; therefore we questioned the difference between the estimate and the purchase order documentation.

6. Subcontract Costs

a. Summary of Conclusions:

During our examination we reviewed [REDACTED] of the proposed subcontract costs. Based on our evaluation of the sample items, we questioned [REDACTED] of the proposed costs.

[REDACTED]

b. Basis of Contractor's Cost:

KBR utilized subcontractor files in support of its proposed costs. These subcontract files generally contained bids for selected vendors. They also contained some pricing history applicable to change orders and purchase orders issued under the subcontracts.

c. Audit Evaluation:

We reconciled the proposed amounts to KBR's procurement files in some cases. When possible we reviewed these files to determine that proper cost or price analyses were performed.

[REDACTED] We compared these proposed costs to the various vendor quotes to verify reasonableness, validity, and existence of competition.

[REDACTED]

Procurement Source	Item Description	Contract Cost	Unsupported Cost	Questioned Cost	Note
AJS-0005 MA	EII – CPS5 Additional Costs				(i)
AJS-0005 MA	EII – Support at Qarmat Ali				(i)
Construction Cost	Site Preparation				(ii)
Construction Cost	Site Preparation				(ii)
Construction Cost	Site Preparation				(ii)
PO 1020	MW Leased Power Generator				(ii)
JK-S0119	Installation and Commissioning				(iii)
JK-S0119	Technical Service Rep				(iii)
JK-S0119	Initial Prep visit				(iii)
All other items	Various				
TOTAL (Examined)					

Questioned Cost

[REDACTED]

An LVPA generally compares the purchase price of the assets to the cumulative lease payments, considering anticipated length of ownership, salvage value, time value of money and ownership costs. The use of LVPA is a normal and prudent business practice used by major corporations to determine the best value for acquiring property and equipment.

It should be noted that, over the course of evaluation of task order definitization proposals our analysis of various cost elements (subcontracts, material, equipment, and ODC) shows that KBR has leased and is still proposing to lease significant amounts of assets. In some cases the leases are short term (30 – 60 days) but most leases are proposed for extended periods of time, most frequently for 6 – 12 months with routine extensions for similar periods.

During several of our task order definitization proposal evaluations, we found evidence of some LVPAs having been performed by KBR. In the LVPAs performed by KBR, the breakeven point (the date at which it is more advantageous to purchase than to lease) ranged from 5 to 10 months [REDACTED]

[REDACTED]

[REDACTED]

An LVPA generally compares the purchase price of the assets to the cumulative lease payments, considering anticipated length of ownership, salvage value, time value of money and ownership costs. The use of LVPA is a normal and prudent business practice used by major corporations to determine the best value for acquiring property and equipment.

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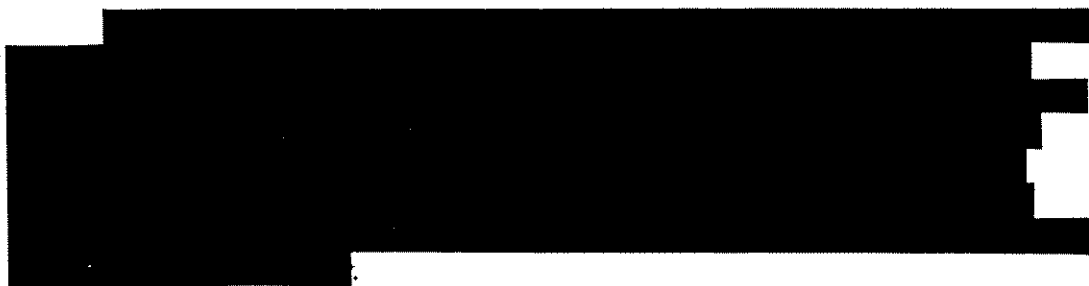
During several of our task order definitization proposal evaluations, we found evidence of some LVPAs having been performed by KBR. In the LVPAs performed by KBR, the breakeven point (the date at which it is more advantageous to purchase than to lease) ranged from 5 to 10 months. [REDACTED]

(iii) KBR proposed these costs to provide customer support services worldwide. These services include:

- Supervising or carrying out the complete Installation and commissioning of new or relocated equipment.
- Providing long or short term Operation and Maintenance services.
- Carrying out routine service work.
- Providing a troubleshooting service.
- Providing 'hands on' site training for User's operators and maintenance personnel.

Price breakdown is as follows:

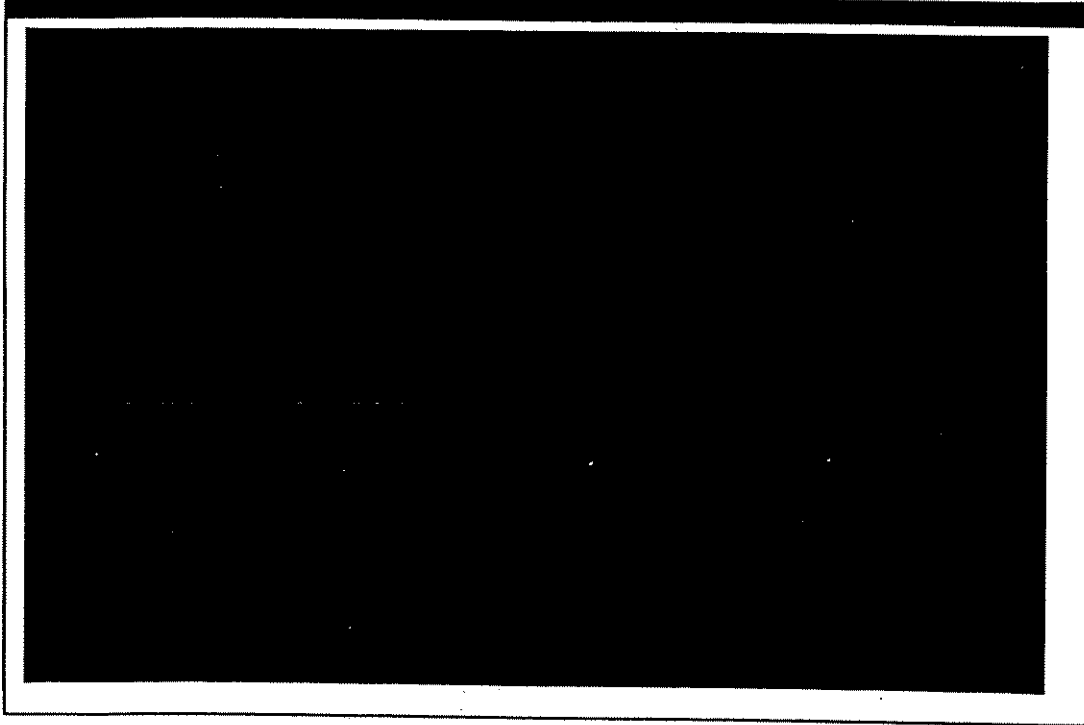
Subcontract Value
Initial site preparation
Thirty-day technical support
Cost Over-run
Total



CONTRACTOR ORGANIZATION AND SYSTEMS

1. Organization

Halliburton's business is organized into two groups, the Engineering and Construction Group and the Energy Services Group (ESG). ESG includes four business segments – Drilling and Formation Evaluation, Fluids, Production Optimization, and Landmark and Other Energy Services. The Engineering and Construction Group operates as KBR and provides engineering, procurement, construction, project management, and facilities operation and maintenance for oil and gas and other industrial and governmental customers.



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Halliburton revenues and personnel worldwide for prior fiscal years and projected revenues for FY 2004 are as follows:

	2004	2003	2002	2001
Total revenues (in millions)		\$16,271	\$12,572	\$13,046
U.S. Government sales		26%	<10%	<10%
Personnel		101,000	83,000	85,000

2. Systems

a. Accounting System

[illegible]

[REDACTED]

[REDACTED]

[REDACTED]

b. Estimating System

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

c. Subcontract Management System

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

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General information on audit matters is available at <http://www.dcaa.mil>

RELEVANT DATES

Audit Request dated June 9, 2004 and received *June 29, 2004
(*Marks the date we received the second submission of proposal documentation)

SUPPLEMENTAL AUDIT REPORT AUTHORIZED BY:

/signed/
James Carrera
Branch Manager
DCAA Iraq Branch Office

SUPPLEMENTAL AUDIT REPORT DISTRIBUTION AND RESTRICTIONS

DISTRIBUTION

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RESTRICTIONS

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4. Do not use the information contained in this audit report for purposes other than action on the subject of this audit without first discussing its applicability with the auditor.

**DCAA IRAQ BRANCH OFFICE
KUWAIT BRANCH OFFICE
AUDIT REPORT No. 2131-2004F27000005**

The above reference audit report is attached in its entirety.